BANCO CENTRAL DO BRASIL

## Minutes of the 81st Meeting of the Monetary Policy Committee (Copom)

**Date:** February 18th and 19th
**Place:** Central Bank's Headquarters meeting room of the 8th floor (on Feb 18th) and 20th floor (on Feb 19th) – Brasília – DF

**Called to Order:** 4:00 PM on Feb 18th and 11h15 AM on Feb 19th
**Adjourned:** 7:00 PM on Feb 18th and 4:40 PM on Feb 19th

**In attendance:**
**Members of the Committee**
Henrique de Campos Meirelles – Governor
Beny Parnes
Carlos Eduardo de Freitas
Edison Bernardes dos Santos
Ilan Goldfajn
Luiz Fernando Figueiredo
Sérgio Darcy da Silva Alves
Tereza Cristina Grossi Togni

**Department Heads (all present on February 18th)**
Altamir Lopes – Economic Department
Daso Maranhão Coimbra – International Reserve Operations Department
José Antonio Marciano – Department of Banking Operations and Payment System
José Pedro Ramos Fachada Martins da Silva – Investor Relations Group
Marcelo Kfoury Muinhos – Research Department (also present on February 19th)
Sérgio Goldenstein – Open Market Operations Department

**Other participants (all present on February 18th)**
Antônio Carlos Monteiro – Executive Secretary
João dos Reis Borges Muniz – Press Secretary

The members of the Monetary Policy Committee analyzed the recent performance of, and prospects for the Brazilian and international economies under the monetary policy framework, designed to comply with the inflation targets established by the government.

## Economic Activity

Recent economic indicators have pointed out some deceleration in activity. In December, both industrial output and retail sales contracted, after having posted monthly increases throughout the second half of 2002. The fall in real income and the worsening in credit market conditions persist as main contractive factors, offsetting the positive effect of the extraordinary disbursements from the FGTS. At the same time, the uncertain global environment does not encourage a recovery in domestic investment. Export growth and import substitution remain as key factors to support economic activity.

According to seasonally adjusted data from Fecomercio-SP, real retail sales in greater São Paulo fell 4.3% in December as compared to the previous month. In January, preliminary data suggest a new contraction, of 1.68%. Accounting for the January figures, retail sales returned to the first half of 2002 level.

The Fecomercio-SP survey on consumer confidence showed deteriorating expectations in February, mirroring the growing inflation concerns. The IIC stood at 102.5 in February from 106.7 in January, in a scale ranging from 0 to

200, with reductions of 1.9% and 4.9% for current and future consumption intentions, respectively. These decreases took place after a substantial recovery in the last quarter of 2002.

Regarding default rates in the retail trade sector, the share of returned checks substantially increased in January, reaching 5.3%, the historical peak for the series. ACSP data indicated that, though the cancelled default registrations remained high in January, the fact that the number of new arrears increased forced the delinquency rate up, when compared to December.

The default rate in non-earmarked credit operations did not follow the trend in the retail sector, remaining at 8%. Corporate default rates increased 0.1 p.p. in January to 4.3%, roughly stable since July 2002. As far as individuals are concerned, the default rate diminished 0.3 p.p., standing at 14.5%. It is worth stressing the 0.9 p.p. fall in arrears in overdraft accounts.

Investment indicators fell again in December, repeating the trend observed throughout the semester due to the uncertainties of the period. Considering December data, the investment rate closed the year at 17.7% of GDP compared to 19.2% in 2001. All components of fixed investment fell in 2002.

Regarding capital goods, the 27% drop in output of energy generation machinery should be mentioned, due to the conclusion of the investment cycle triggered by the energy rationing. On the other hand, agricultural machines output grew 18.6% due to the increase in this sector real income.

Industrial output fell 1.8% s.a. in December as compared to November, breaking off the growing trend noticed since June. The fall in manufacturing affected 18 out of 20 industrial activities and followed the reduction in industrial sales surveyed by the CNI in November and December (-7.1% and –1.1% s.a., respectively). The 7% reduction in mineral extraction output was due to prescheduled maintenance interruptions in oil and gas fields. Considering the December figure, industrial production grew 2.4% in 2002, boosted by the 10.7% expansion in mineral extraction output, mainly oil and gas. The 1.4% growth rate in manufacturing output was led by the agribusiness and exports' sectors.

Concerning business sentiment, the CNI survey tracked some recovery in confidence at the end of 2002 and in the beginning of 2003. The FGV survey of the manufacturing sector, conducted with 1,100 companies all over Brazil, indicated that the business community expects a recovery in demand in a 6-month horizon, though anticipating a short-term contraction. The low level of industrial inventories is one factor that boosts business confidence. Also worth mentioning, the level of capacity utilization in January (80.8%) does not restrict activity except in very specific industries.

Employed workers grew 0.2% in December, s.a., and 3.6% for the year when compared to 2001, according to data from the Ministry of Labor and Employment. The jobless rate measured by the new monthly survey by IBGE, including the six largest metropolitan areas of Brazil, fell to 10.5% in December from 10.9% in November.

The trade balance posted a US$1.2 billion surplus in January, with a 21% growth in exports (US$4.8 billion) and a 4.1% fall in imports, both compared to the same month of 2002. Up to the second week of February (including 10 working days), the trade surplus reached US$789 million, averaging US$253 million/day for exports and US$175 million/day for imports.

Adding up briefly, activity level lost *momentum* at the end of 2002, after a positive performance throughout the second half of the year. Despite the continuity of the external adjustment, as well as positive signs in business sentiment, domestic expenditure contracted due to the fall in real income, the worsening in credit market conditions and the falling investment caused by the uncertain environment, mainly on the external front.

## External Environment

The external scenario remained stressful in the last few weeks, reflecting growing tension about a possible war in the Middle East. Besides the direct concerns about the war, in relation to length and its economic, social and political outcomes, global financial markets anticipated the risks that any decision is not unanimously taken by the UN Security Council.

This framework helped to pull up oil prices, deteriorating the uncertainties regarding the global economy prospects, even in a short-lasting war scenario. This environment complicates the outlook for emerging market economies, mainly the ones dependent of external funding.

Doubts about the US recovery persist, as the uncertainties about war in Iraq do not encourage investment expenditure. GDP growth decelerated in the last quarter of 2002, to 0.7%, supported by government consumption expenditures (up 4.6%). Personal consumption (about 2/3 of GDP) increased by only 1%, the lowest rate in nearly ten years.

In the euro area economic stagnation continues, led by the German economy. The European Central Bank maintained the main refinancing rate at 2.75% in its last meeting

In Japan, the most recent economic data showed that the economy has stabilized, but doubts persist about a sustained recovery. In December, though exports fell, industrial orders increased when compared to November. GDP grew 2% in annual terms in the last quarter of 2002, according to a preliminary estimate.

In Argentina, economic activity resumed the upward trend, supported by the import substitution process. The sharp fall in imports helped to achieve a record US$16.4 billion trade surplus in 2002.

## Prices

In January, the trend of the main price indices was not uniform. Consumer inflation grew, after having decelerated somewhat in December, whilst wholesale inflation fell again, particularly for agricultural prices. The IPCA increased 2.25% compared to 2.10% in December. The IGP-DI reached 2.17% in the month (2.70% in December), reflecting changes of 2.21% in the IPA, 2.32% in the IPC and 1.51% in the INCC. For the first time since April 2002, the IPCA monthly growth was higher than the IPA's.

The growth of consumer price indices was mainly due to the increases of fuel prices and urban transport fares. Food prices decelerated, following the trend observed since the end of November for wholesale agricultural prices.

In the IPCA, prices of non-food goods increased 2.28% and contributed 1.74 p.p. to the monthly variation. Gasoline, with a 8.82% increase, and readjustment of urban transport tariffs in 5 out of the 11 surveyed capitals by IBGE (Porto Alegre, Fortaleza, Salvador, Belo Horizonte, and São Paulo), with an average increase of 4.99%, were the items that mostly contributed to the monthly result, 0.39 p.p. and 0.23 p.p., respectively. Food prices, even having increased significantly, grew less in January (2.15%) as compared to December (3.91%).

With respect to the IGP, the 2.21% increase in the IPA resulted from increases of 1.16% in agricultural prices and 2.64% in industrial prices, both decelerating as compared to the previous two months. Regarding agricultural prices, the deceleration was even sharper due to the beginning of the new harvest, besides decreases in the prices of some agricultural *commodities*, resulting from lower international prices and an appreciated exchange rate (monthly averages). In the industrial prices, the deceleration was less intense, although some groups as chemicals (fuel and lubricants) and textiles still posted some pressure.

In February, inflation shall cool down somewhat. In the IPCA, regulated and monitored prices are expected to be under pressure due to the residual effect of the readjustments of fuel prices and urban transport fares, let alone the mobile phone tariffs that were readjusted in February. Among the free market prices, the highest variations may come from the segment of education. The readjustment of monthly school fees, for methodological reasons, influences the IPCA variation with more intensity in February, differently from other indices, whose higher effect occurred in January.

## Money Market and Open Market Operations

Uncertainties in the external scenario and the release of inflation figures above market consensus brought about expectations of a higher over-Selic target on the Copom February meeting. On February 18th, eve of the Copom decision, the spreads of 1-month and 6-month interest rates were 120 and 284 b.p., respectively.

A total of US$4.2 billion in securities and FX swaps maturing in February was rolled over through swap contracts. On the February 3 rollover, the equivalent to US$1.7 billion was placed as contracts with tenures ranging from 1 month to 5 years. The auctions were carried out at rates higher than in the January 22 rollover, due to the increase in the slope of the exchange rate coupon curve. The February 13 rollover (US$2.5 billion of swaps were contracted with tenures ranging from 1 to 29 months) benefited by the decrease of the short-term coupon, due to new private external funding and the rollover of the Banco Central's FX credit lines.

The Treasury carried out four LFT auctions, with higher volumes at each event. Financial volume reached R$20.8 billion, with an average maturity of 348 days. Aiming at reducing the concentration of maturities, the Treasury held a purchase auction of LFT, draining the equivalent to R$1.6 billion from the market, in securities maturing in April. In the period, approximately R$0.7 billion was placed in NTN-C, with tenures of 5, 14 and 18 years.

From January 24 on, the Banco Central has altered its strategy of intervening in the open market, aiming at lengthening the tenure of its repo operations. Usual interventions had their tenures lengthening from 1 to up to 5 working days. Also, five 1-month repo operations were carried out, draining R$37.2 billion from the market.

Securities settlements from January 23 to February 18 caused a contractive monetary impact of R$6.5 billion, basically due to net placements of R$10.6 billion of LFT, partially offset by net redemptions of FX-indexed securities (R$4.4 billion).

In January, domestic securitized public debt increased by R$13.7 billion (+2,2%), due to net placements of R$2.6 billion in securities and interest accrual.

## Assessment of Inflation Trends

The identified shocks and their inflationary impact were reassessed according to newly available information. The scenario considered in the simulations assumes the following hypotheses:

1. The projection for the increase in gasoline prices was revised to 8.0% for 2003, including the rises in the beginning of the year. An increase of 8.0 p.p. is forecasted for the prices of bottled gas, as compared to the January Copom meeting;

2. Regarding the previous meeting, the forecasted rise in household electricity tariffs for 2003 decreased to 27.1% from 30.3%, due to the revision of the readjustments proposed by the Aneel for this year;

3. For the set of regulated and monitored prices, which had a weight of 27.9% in the January IPCA, an increase of 15.9% is projected for 2003, from which 3.8% has already occurred in January. The decrease in the projections for household electricity tariffs was offset by higher prices of gasoline, bottled gas, urban transport, and interstate transport. For 2004, the forecast increase for the set of regulated and monitored prices is 8.7%. The increase of 0.7 p.p. compared to the January estimate was due to the revision of expectations for the IGP-M, since the Copom assumes that all the regulated and monitored prices follow the change of the IGP-M for the specified year;

4. The projection for the 6-month spread over the Selic rate, which utilizes an error correction-based model specification, was 200 b.p. for the first quarter of 2003 though gradually reaching –150 b.p. at the end of 2004.

Core inflation calculated with the exclusion of household food items and of regulated and monitored prices posted a 1.38% increase in January, a significant decrease in comparison to the 1.66% observed in December, but still higher than the observed in the previous months. In January, the 12-month accumulated change was 9.69%. Core inflation calculated under the trimmed-mean method registered a 1.32% increase in January, back to the value registered in November 2002 and slightly below the December figure (1.36%). In the last 12 months, the core increased by 9.70%. Regarding core inflation of IPC-BR, calculated under the symmetric trimmed-mean method, the inflation rate reached 1.39% in December and 8.76% in 12 months.

The accumulated variation for the IPCA in 12 months increased to 14.47% in January 2003, as compared to 12.53% in December 2002. In the last 12 months, free market prices contributed 8.74 p.p. to inflation, while prices regulated and monitored contributed 5.73 p.p.

Regarding fiscal policy, it is assumed that the primary surplus target for this year will be achieved (4.25%). The other related assumptions established in the previous meeting were maintained.

From the simulation exercises with several specifications of the structural model, it has been concluded that the maintenance of the interest rate at 25.5% p.a. and of the exchange rate at the prevailing on the eve of the Copom meeting indicates inflation higher than the adjusted target of 8.5% for 2003.

## Monetary Policy Guidelines

In the last year, the confidence crisis regarding the future of the Brazilian economy and the increase in global risk aversion resulted in a U$30 billion decrease in capital inflows to Brazil and a current account deficit adjustment of nearly 3% of the GDP. This external adjustment triggered a sharp exchange rate depreciation (44%), since GDP has grown around 1.6%. The significant exchange rate depreciation represented an important shift in relative prices, what resulted in an inflation rate of 6.6% in the last quarter of 2002. This higher inflation was the major cost inherited from the last year crisis.

The Brazilian economy has been reacting to the last year shock through measures that have recovered the confidence and allowed capital flows to return. The FX inflow was positive in January (US$1.1 billion) for the first time since March 2002, a trend sustained in February. Regarding the primary placement of public securities, the Treasury has been issuing larger volumes of LFT with no pressures on yields or tenures. On its turn, inflation to the consumer has been decelerating. IPCA moved from the 3.02% peak in November to 2.25% in January. Similarly, free market prices inflation has been decreasing since the 2.53% peak in November to 2.32% in December and 1.64% in January.

There are reasons to believe that inflation may continue to decrease. On one hand, economic activity seems to be decelerating. In the retail sector, the sharpened decrease in real sales in December reflects the fall of real income and worsened credit conditions for the consumers. Industrial production, in the same month, interrupted the growing trajectory drawn in the previous six months and, based on leading indicators, may continue to move backwards in January. In this sense, it is important to consider the future impact on inflation of the accumulated increase of 750 b.p. in the over-Selic rate since last October. On the other hand, the maintenance of the pace of capital inflows observed in the beginning of this year may imply a higher supply in the FX market and, on a less adverse external scenario, allow some favorable pressure on the exchange rate.

Notwithstanding, there is the risk of inflation to continue in a high level, as the current inflation level shows some rigidity. Due to the inertial mechanism of price formation in the Brazilian economy, the high inflation of the last year has been reflecting in a higher inflation in the beginning of this year. IPCA core inflation in January moved backward as compared to the previous month, but the variation was higher than the observed in the three first quarters of 2002. Estimates for consumer price indices in February continue to show high rates of inflation, higher than in January. In the second 4-week estimate of February, IPC-Fipe increased by 2.13%, slightly below the first week (2.23%), but well above the second preview of January (1.79%).

Preliminary data of prices collected in the last weeks indicate that free market prices inflation has been decreasing in February, even though there is a strong pressure of items such as *in natura* food and school fees. However, the results of these price collections suggest a high variation in the IPCA compared to the adjusted inflation target trajectory.

As in the last years' trend, regulated and monitored prices continue to put a strong pressure on the consumer inflation. In January, IPCA inflation moved upward due to the significant increase in regulated and monitored prices (3.83%), 2.3 times higher than the free prices average increase. Even weighting 27.9%, regulated and monitored prices were responsible for 47% of the January IPCA rate and 40% of the IPCA accumulated in the last 12 months.

As an example, while free market prices inflation reached 1.64% in January, the price of gasoline for the consumer rose by 8.82%, the major individual contribution to IPCA in the month. This increase was due to the passthrough of the 12.8% rise in the refineries on last December 29, besides the increase caused by changes in the basis for calculating the ICMS. Alcohol-based fuel prices increased by 5.96% in January, as compared to 2.96% in the previous month, mainly because of rises endorsed by producers. Prices of diesel oil increased by 11.88% in January, added to the 8.01% increase in December. Price increase in January reflected mainly the 11.3% readjustment in the refineries on December 29.

The readjustment of 4.99% in urban transport fares has also put a strong pressure on regulated prices in January, even after the strong increase in December (2.67%). Local governments of Belo Horizonte (10.43%), São Paulo (10.00%), Salvador (8.18%), Porto Alegre (4.17%), and Fortaleza (1.67%) practiced the most significant increases. Interstate bus fares were also readjusted by 7.18%, with pressure coming from the increases in Belo Horizonte (17.18%), São Paulo (12.63%), Belém (6.36%), Porto Alegre (5.93%) and Salvador (5.33%).

Moreover, the 2.73% increase in the household electricity tariff was due to the readjustments in Rio de Janeiro (10.97%) and Brasília (8.43%). In Rio, one of the concessionaries carried out a 28.56% contractual readjustment.

It should be highlighted that the effects of the readjustments in regulated and monitored prices may not only contribute directly to inflation but also risk propagating secondarily to free market prices.

It is important to say that over the three first quarters of 2003 the 12-month accumulated inflation shall remain high, carrying the statistical effects of the inflation of the last quarter of 2002. Under this scenario, it is important the perception that inflation over 2003 keeps falling.

Copom understands that in this moment, when inertia in Brazilian economy transfers the impact of the last year's shock to a higher inflation this year, monetary policy should be firm enough to eliminate the risk of a shift in the inflation level. So, Copom evaluates an additional effort in monetary policy as appropriate.

Besides, Copom understands that not only the economic policy actions of the Government but also the reactions of the society against inflation are important to a less costly reduction of inflation. In this sense, recent measures adopted by the Government aiming at reaffirming fiscal responsibility and fiscal consistence together with structural reforms are beneficial not only in the direct related areas but also boost the monetary policy efficiency. As the Brazilian experience clearly shows, the effort that society make to keep prices stable is fundamental to protect itself against the inflation tax and its regressive impacts and to the development strategy. The stability ensures the capacity of planning and investing through a more accurate predictability and lengthening of horizons.

As a result, the Copom decided, unanimously, to increase the target for the over-Selic rate to 26.5% p.a. Afterwards, the Central Bank's Board decided, unanimously, to increase the reserve requirements on demand deposits to 60% from 45% as to contribute for the fall in inflation in the coming months and to diversify the instruments of monetary policy.

BANCO CENTRAL DO BRASIL

At the close of the meeting, it was announced that the Committee would meet again on March 18th, for technical presentations, and on the following day, in order to discuss the monetary policy guidelines, as established in Communiqué 10,187, of October 2, 2002.

**Acronyms**

| | |
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| ACSP | São Paulo Trade Association |
| Aneel | National Electric Energy Agency |
| b.p. | basis points |
| BRL | Brazilian Real |
| Fecomércio-SP | São Paulo State's Federation of Commerce |
| FGTS | Time in Service Guarantee Fund |
| GDP | Gross Domestic Product |
| IBGE | Brazilian Institute of Geography and Statistics |
| ICMS | Tax on the Circulation of Goods and Services |
| IGP–DI | General Price Index – Domestic Supply |
| IGP–M | General Price Index – Market |
| IIC | Consumer Intentions Index |
| INCC | National Index of Civil Construction |
| IPA | Wholesale Price Index |
| IPC–BR | Consumer Price Index – Brazil |
| IPC-FIPE | Consumer Price Index of the Economic Research Institute Foundation |
| IPCA | Consumer Price Index - Extended |
| LFT | National Treasury Letters (floating) |
| LTN | National Treasury Letters (fixed rate) |
| NTN–C | National Treasury Note – C Series (price index) |
| p.a. | per annum |
| p.m. | per month |
| p.p. | percentage point |
| s.a. | seasonally adjusted |
| UN | United Nations |